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COMMENTS

on

**"PRESENTATION OF FACTORS THAT AFFECT
PRICES OF REFINED PETROLEUM PRODUCTS"**

submitted to the

FEDERAL TRADE COMMISSION

September 14, 2001

The Federal Trade Commission has requested comments on "Factors That Affect Prices of Refined Petroleum Products." These comments and the testimony received at the August 2 public conference are part of a comprehensive investigation into the central factors that cause price spikes and product shortfalls.¹ The Independent Fuel Terminal Operators Association ("IFTOA") hereby submits these comments identifying several key factors that contribute to levels of supply and price volatility which the Association believes require further investigation by the Commission.

I. Lack of Fungibility

A fundamental factor contributing to price increases is the lack of uniformity among gasolines used in the country. Environmental regulations promulgated by both the Federal and State governments have resulted in the use of different gasolines in different markets, depending on their air quality. In addition, the regulations generally prohibit the substitution of fuels even when market conditions would warrant it. Thus, markets cannot respond properly or in a timely manner when problems arise.

If a shortfall occurs in a region, prices typically increase rapidly; product would automatically flow from markets with lower prices to the market-in-need with higher prices. However, artificial restraints - environmental requirements that result in gasolines with different parameters -- inhibit the natural flow of such product.

For example, in 2000 when a substantial shortfall occurred in Chicago due to pipeline closure, prices rose and stayed high for an unnecessarily long period of time. Gasolines from other markets did not meet the environmental standards required in Chicago and thus could not be used. In addition, even if reformulated gasoline refined in the Gulf Coast would meet the Chicago standards, it contained MTBE, an oxygenate, while reformulated gasoline typically used in the Chicago area contained ethanol. There was not sufficient tankage to handle two separate fuels, and it was not possible to mix the two; this restriction further limited supply.

Thus, as a result of lack of fungibility among gasolines, markets respond to imbalances and price signals much more slowly than would normally occur. Imbalances with their attendant adverse consequences are prolonged. Accordingly, environmental

¹ 66 Fed. Reg. 37032 (July 16, 2001).

regulations should be amended to minimize the differences among gasolines, and flexibility should be provided to facilitate the flow of gasolines from one market to another if imbalances occur.

II. Transition from Winter to Summer Gasoline

Under the Environmental Protection Agency ("EPA") regulations, terminals must transition their tanks from winter to summer gasoline by May 1. This requirement is stringently applied and compels terminals to engage in a complex process of completely draining tanks, piping and all other systems of the winter gasoline before receiving the summer fuel. This process results in a significant disruption of service at the terminal, which is both costly and cumbersome.

Moreover, it is virtually impossible to eliminate completely all molecules of winter gasoline from the system because some will always remain in residual pockets throughout the piping and in the bottoms of storage tanks. In addition, winter and summer gasolines do not usually blend thoroughly, and in some cases a small amount of winter gasoline may float on top of the summer gasoline that has filled the tank. Thus, if the tank were tested, a sample from the top portion would fail, while virtually the entire tank would be in compliance.

Accordingly, the EPA should amend its regulations so that the Agency would determine compliance with the summer gasoline standards by testing the product that is introduced into commerce and flows over the terminal rack rather than testing product held in storage. Such an approach would provide a terminal greater flexibility during the transition period but would meet the Clean Air Act standards that have been mandated.

III. Unocal Patent

In 2000, the Court of Appeals for the Federal Circuit upheld a lower court's ruling that six major integrated oil companies had infringed on a patent held by Union Oil Company of California ("Unocal") for low-emission gasoline developed for use in California. The companies were ordered to pay Unocal damages in the amount of 5.75 cents per gallon, totaling approximately \$90 million for sales during a five-month period in 1996. Ongoing litigation seeks damages for several years thereafter.

Originally, members of the petroleum industry, excluding the participants in the litigation, were generally unaware of the case and believed that the action was limited to the unique

gasoline sold in California known as CARB gasoline. However, beginning in 2000, with the production and sale of reformulated gasoline Phase II, industry became concerned that the Unocal patent would be applicable to most gasoline sold in the United States. Thus, to avoid potential liability, companies realized that they had three options: (1) cease production; (2) pay a licensing fee (approximately 1.2 to 4.2 cents per gallon); or (3) "blend around" the patent (produce a gasoline with specifications that do not violate the patent). Petroleum companies have availed themselves of all three.

Some have stopped producing reformulated gasoline or substantially reduced their production; some pay a licensing fee, thereby increasing their costs; and finally, some blend around the patent -- also increasing costs. Seasonally, this loss of supply has had a dramatic impact on gasoline prices.

IV. Jones Act

Under the Merchant Marine Act of 1920, as amended, 46 USC App. 883, petroleum shipped between two points within the United States must travel on certain U.S.-flag vessels known as "Jones Act" vessels. These vessels are manned by U.S. sailors and owned by U.S. citizens. They are generally more expensive to charter than competing foreign-flag vessels. The statute is designed to support the U.S. maritime unions and their members. While the law increases the cost of shipping in the United States, the petroleum industry is not considered an opponent.

However, during times of crisis such as a winter with over 100 ice storms or a winter in which major waterways are frozen solid, it is not always possible to obtain a Jones Act vessel to ship product, and fuel supply is usually tight. At such times, a foreign vessel suitable for the voyage may be available, but cannot be used without the supplier obtaining a special waiver from the Federal Government, P.L. 891 (1950). These waivers are not readily forthcoming even if warranted.

For example, in 1989-90, the waterways in New York were frozen and the Coast Guard was having great difficulty clearing them for vessel traffic. A utility in upstate New York required fuel oil to generate power. The utility served thousands of residential customers, hospitals and schools. It had run low of fuel and had only three days supply. No Jones Act vessel was reasonably available to bring additional oil to the facility, but the supplier found a single foreign-flag ship to handle the trip. Despite the dire circumstances, the Federal Government told the

supplier informally that no waiver of the Jones Act requirement would be given because a Jones Act vessel was available, even though it was much larger than needed and was currently located far outside the area to be served. This outcome is the typical response to requests for waivers.

Strict enforcement of the Jones Act during an emergency further restricts supply at the very time it is needed most. Accordingly, while the law provides for a waiver of the Jones Act, new and more practical guidelines for implementation are needed to ensure that during true crises, the waiver may be granted in a timely manner - within 24 to 48 hours.

V. Maintenance of Inventories

Finally, some groups concerned about shortfalls of supply and corresponding price increases have advocated requiring the petroleum industry to maintain inventories of refined petroleum products at levels above those needed to operate their facilities. Such inventories would significantly increase consumer costs and exacerbate the very problem they were designed to minimize. Moreover, it is not clear that such a mandate would in fact actually increase inventories held; instead, it is likely that the same volume of supply would be maintained but, due to the governmental mandate, less product would be available to meet commercial needs. Moreover, mandated inventories would make the transition from winter to summer gasoline an impossibility. A terminal would have to sell off all of the excess winter inventory to comply with the summer standard; there would be no market for such fuel.

If the industry were forced to maintain such inventories, it would incur a substantial cost - several cents per gallon. These costs would be passed on to the consumer in the form of higher prices on a continuing basis. It would raise the price of these products permanently. In contrast, supply imbalances and price spikes are temporary phenomena that typically occur once every few years for several weeks. Markets, particularly those not artificially restrained, adjust quickly. Additional product is supplied and prices drop.

Therefore, a solution that permanently raises the cost of fuel to all consumers to prevent a short-lived, temporary increase would not be prudent. A better policy would allow the market to establish appropriate levels of inventory and if a price spike occurs, government assistance to vulnerable consumers is a more viable solution. The Low-Income Home Energy Assistance

Program helps low-income families with heating bills and should be increased; similar assistance could be provided for independent truckers purchasing diesel fuel to power their vehicles. Mandatory maintenance of inventories is not the answer to maintaining reasonable prices for these essential fuels. Such mandates should not be adopted.

VI. Conclusion

Based on the foregoing, the Independent Fuel Terminal Operators Association recommends that the Government:

- Streamline the number of motor fuels required to meet environmental regulations;
- Simplify the process for transitioning from winter to summer gasoline and provide the industry with greater flexibility;
- Establish workable guidelines for granting Jones Act waivers when true emergencies occur that impede the distribution of refined petroleum products and ensure that a waiver is granted timely; and
- Permit the petroleum industry to establish appropriate levels of inventory held; avoid any Government mandates.

IFTOA strongly believes that such measures would enhance supply, contribute to price stability, and protect the interests of U.S. consumers.

Thank you.